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The future of insurance accounting – preparing for change

13 May 2015

Institute and Faculty of Actuaries Asia Conference

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Agenda

1. **Where are we now?**
2. **Technical update**
    - Insurance contracts:
        - Timeline
        - Overview of measurement model
        - Building block approach
        - Premium allocation approach
        - Business combinations
        - Reinsurance
        - Presentation
        - Participating contracts
        - Transition
    - Financial assets:
        - IFRS 9 - Financial assets and impairment
3. **How are insurers preparing?**

Appendix - Solvency II versus IFRS for insurance contracts

1

Where are we now?

What is wrong with current insurance accounting?

Comparability - accounting methods varying by product and territory

Understanding - it is difficult for investors and analysts to see the key drivers of insurance contract profitability

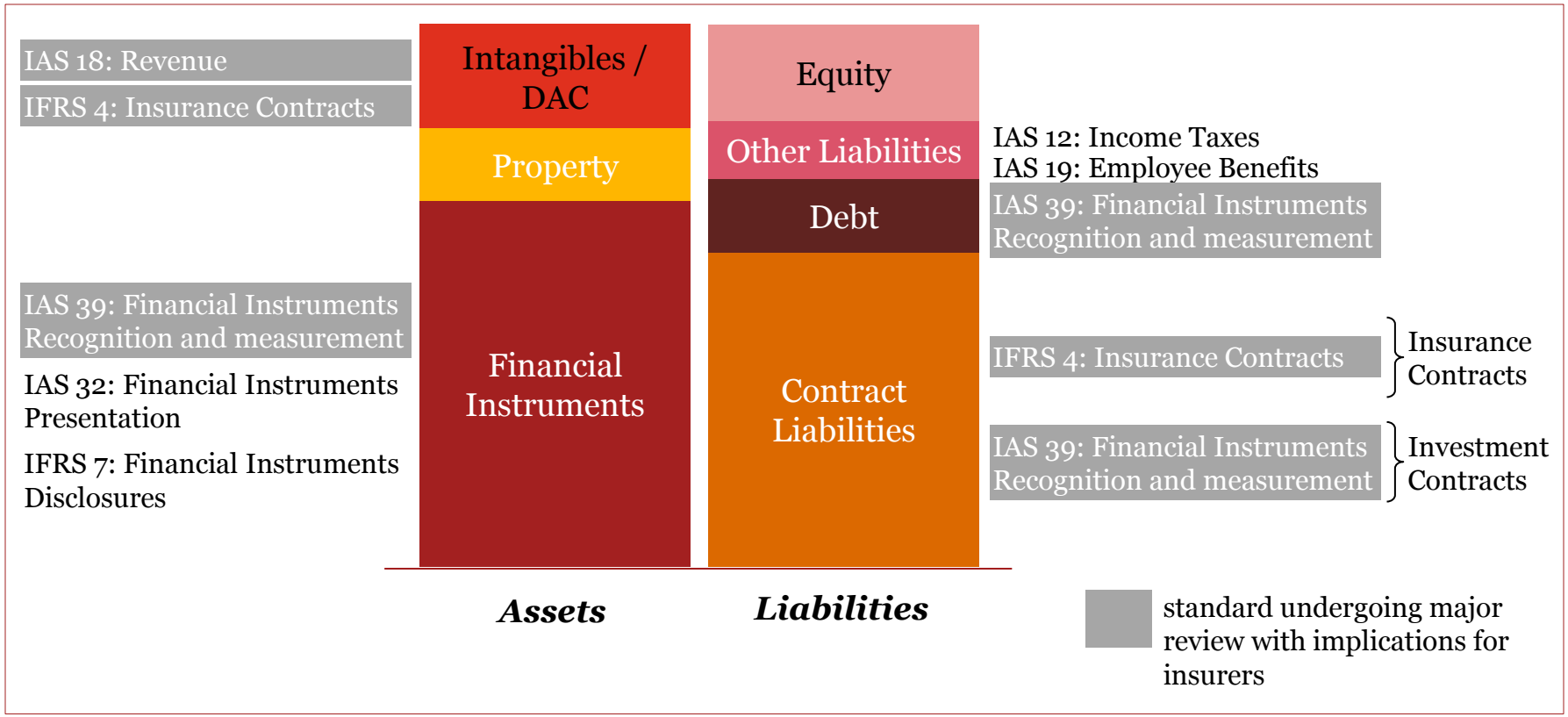
There is not a clear quantitative assessment of risk

No current information about insurance liabilities, due to use of locked in assumptions (in some countries)

Discount rates may not reflect characteristics of the liabilities and hence may not be appropriate

Economic mismatches between asset and liabilities are not always clear

Context: existing IFRS



Other IASB standards also impact insurers, for example: IFRS 13 – Fair value measurement

Proposed IFRS

Insurance contracts standard (to replace IFRS 4)

- Ongoing IASB deliberations following 2nd Exposure Draft in June 2013 (see later sections)

IFRS 9: Financial instruments (to replace IAS 39)

- Classification and measurement of financial assets - Fair value (P&L or OCI) or Amortised cost
- Liability deposit floor retained; affects business classified as "investment contracts" (e.g. Certain unit linked pension contracts)

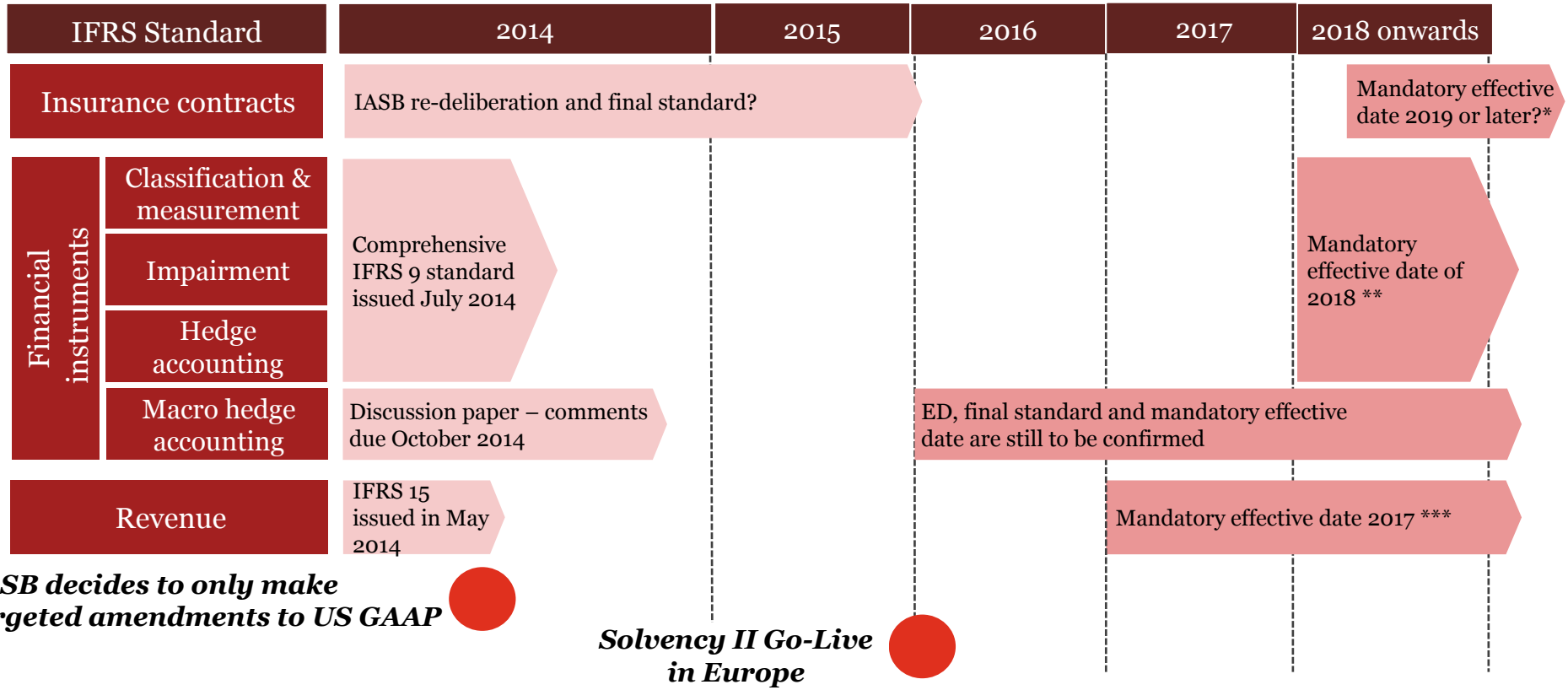
Revenue recognition standard (to replace IAS 18)

- Affects business classified as "investment contracts"
- Retains DAC incremental at contract level (change in second ED)

IFRS 13: Fair value measurement (new standard defining how to fair value)

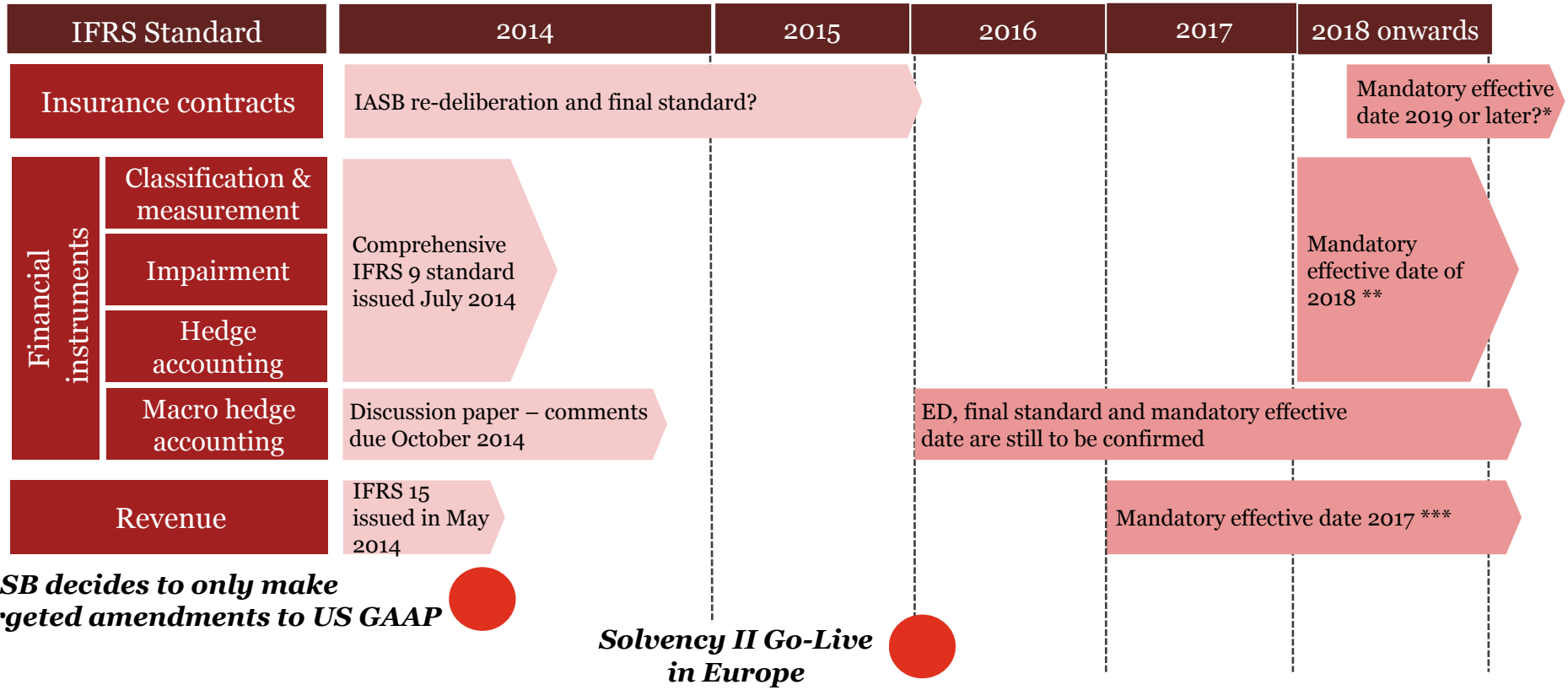
- *" … the price that would be received to sell an asset or transfer a liability in an **orderly transaction** between market participants at the measurement date"*
- The fair value of a liability should reflect the effect of non-performance risk

Timeline



* IASB will decide at future meeting on effective date. One alternative is to provide 3 years between adoption of IFRS 9 and IFRS 4 Phase II.
** IASB has decided to provide additional transition relief for IFRS 9 upon adoption of IFRS 4 Phase II. EFRAG endorsement advice expected in April 2015.
*** Positive EFRAG endorsement advise for 2017 issued in March 2015.

Timeline



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Technical update

Insurance contracts

General model

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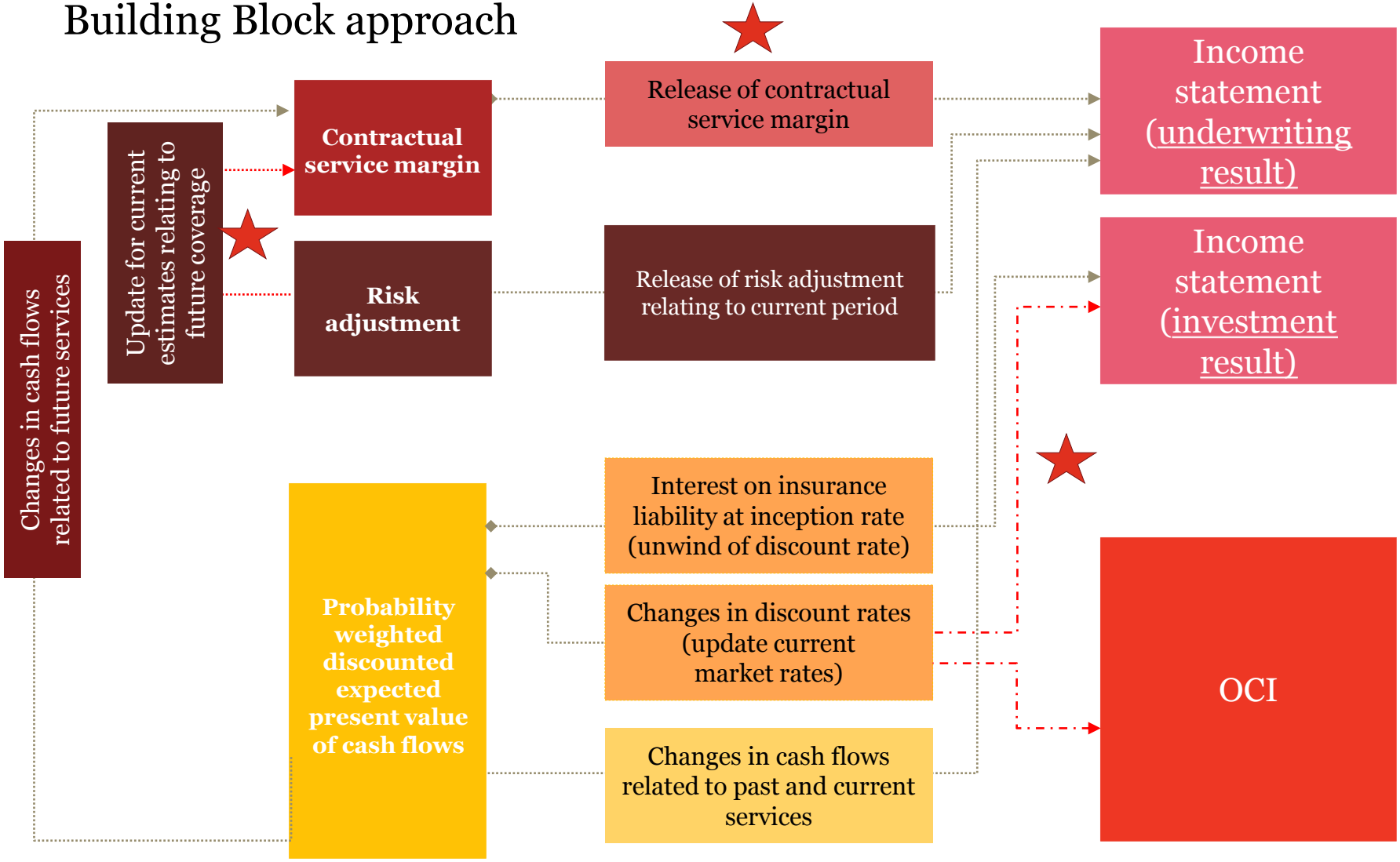
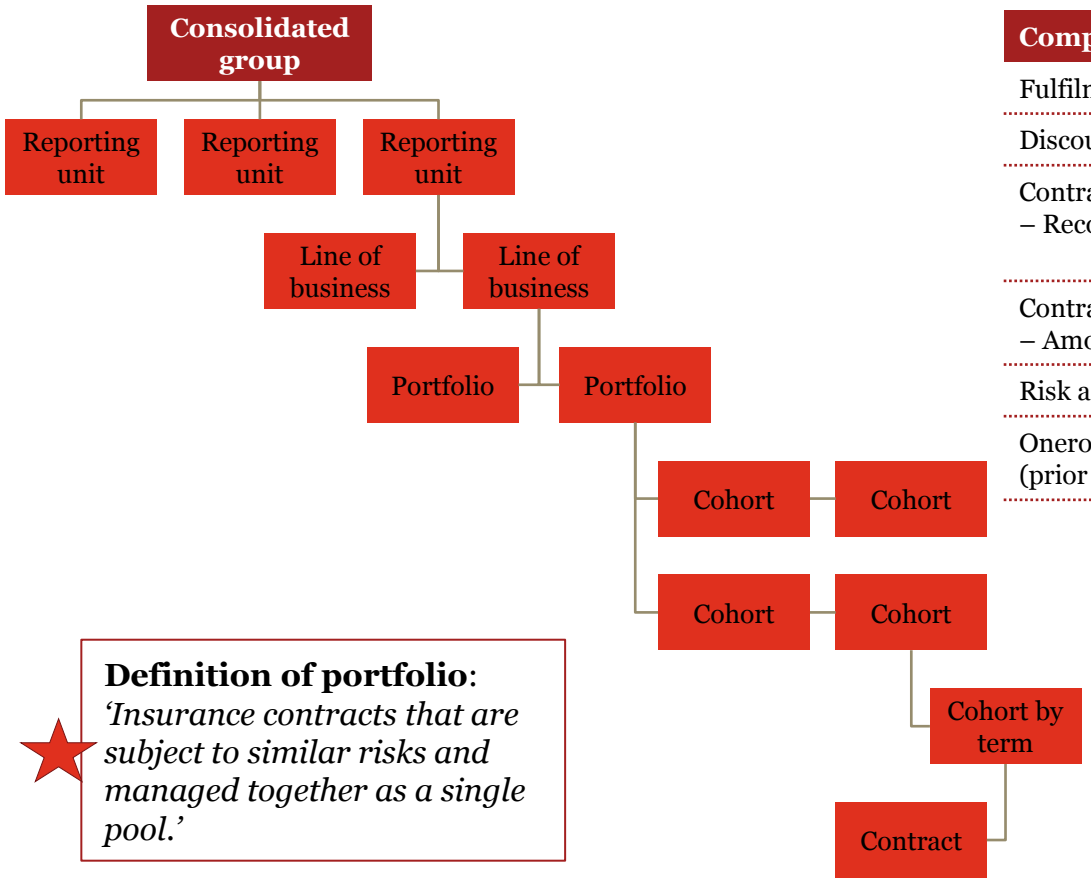
Overview of measurement model

Building Block approach



Overview of measurement model

Unit of account for the BBA and PAA – Driver of complexity



Component	Unit of account
Fulfilment cash flows	Portfolio/Contract
Discount	Liability characteristics
Contractual service margin – Recognition	Individual contract, but can aggregate if it meets objective. Also not combine profit making and loss-making contracts
Contractual service margin – Amortisation	None stated
Risk adjustment	None stated
Onerous contract test (prior to recognition)	Portfolio

Definition of portfolio: *'Insurance contracts that are subject to similar risks and managed together as a single pool.'*

Significant impact on modelling and data requirements

The intention of the IASB is to have a similar unit of account for the onerous contract test under the PAA and BBA

Overview of measurement model
Unit of account for the BBA and PAA

Unit of account

- Portfolio definition no longer refers to contracts that are priced similarly relative to the risk taken on.
- Portfolio definition only used for cash flows
- On initial recognition onerous contracts should not be aggregated with profit making contracts.
- Objective of standard is to measure at individual contract but can aggregate if meets objective. Examples to be provided in the final standard.
- Aggregation of contracts does not meet objective if two groups of policyholders are combined with different levels of profitability

Overview of measurement model

Cash flows – Overview

Contractual service margin

Risk adjustment

Probability weighted discounted expected present value of cash flows

Present value of fulfilment cash flows

- Consistent with observable market prices
- Mean of range of possible outcomes
- Entity perspective for other cash flow estimates
- Incorporates all available information in unbiased way
- Include options, forwards and guarantees related to insurance coverage under existing contract

Overview of measurement model

Discount rate* – Top down vs. bottom up

Contractual service margin

Risk adjustment

Probability weighted discounted expected present value of cash flows

Top down discount rate	
Actual or expected reference portfolio rate	7.0%
Duration mismatches	0.3%
Market risk premium for expected credit losses	-1.0%
Market risk premium for unexpected credit losses	-0.6%
Insurance contract discount rate	**5.7%**

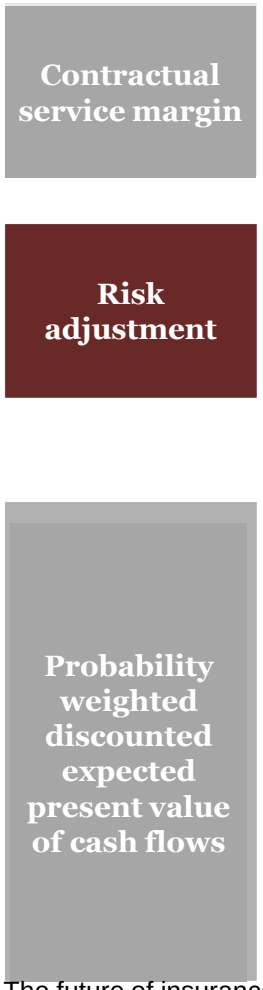
Difference between the two methods not required to be reconciled

Bottom up discount rate	
Insurance contract discount rate	**5.5%**
Liquidity premium	1.5%
Risk free rate of return	4.0%

* Provide additional application guidance in case of lack of market data. Use judgement to:
- Make appropriate adjustments to observed transactions
- Develop unobservable inputs using best available information.
- Unobservable inputs should not contradict relevant market data.

Overview of measurement model

Measurement model - Risk adjustment

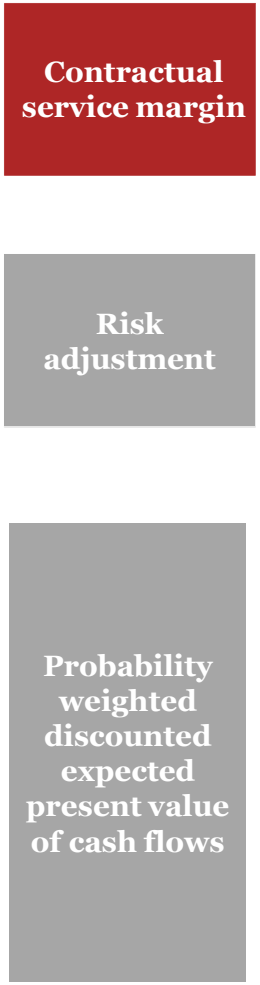


Risk adjustment*

- Reflects compensation that entity requires for bearing uncertainty
- Measures compensation to make entity indifferent between:
  - Range of possible outcomes
  - Fixed cash flows with same expected value
- The CSM is unlocked for changes in risk adjustment for future coverage and other services

* The IASB confirmed that no disclosure requirements will be removed from the 2013 ED, so entities will be required to disclose the confidence level.

Overview of measurement model
Contractual service margin



Contractual service margin (CSM)

- Represents unearned profit in contract
- Unlocked for changes in cash flows related to future services
- Amortised over coverage period in systematic way reflecting services provided
- Service is provided on basis of passage of time (stand ready obligation) and reflecting the expected number of contracts in force
- Contractual service margin cannot be negative, but can be reinstated.
- Previous losses have to be reversed before reinstating the CSM
- IASB confirmed that locked in rates should be used for accretion of interest and calculation of changes in cash flows that offset the CSM.

Insurance contracts

Premium allocation approach

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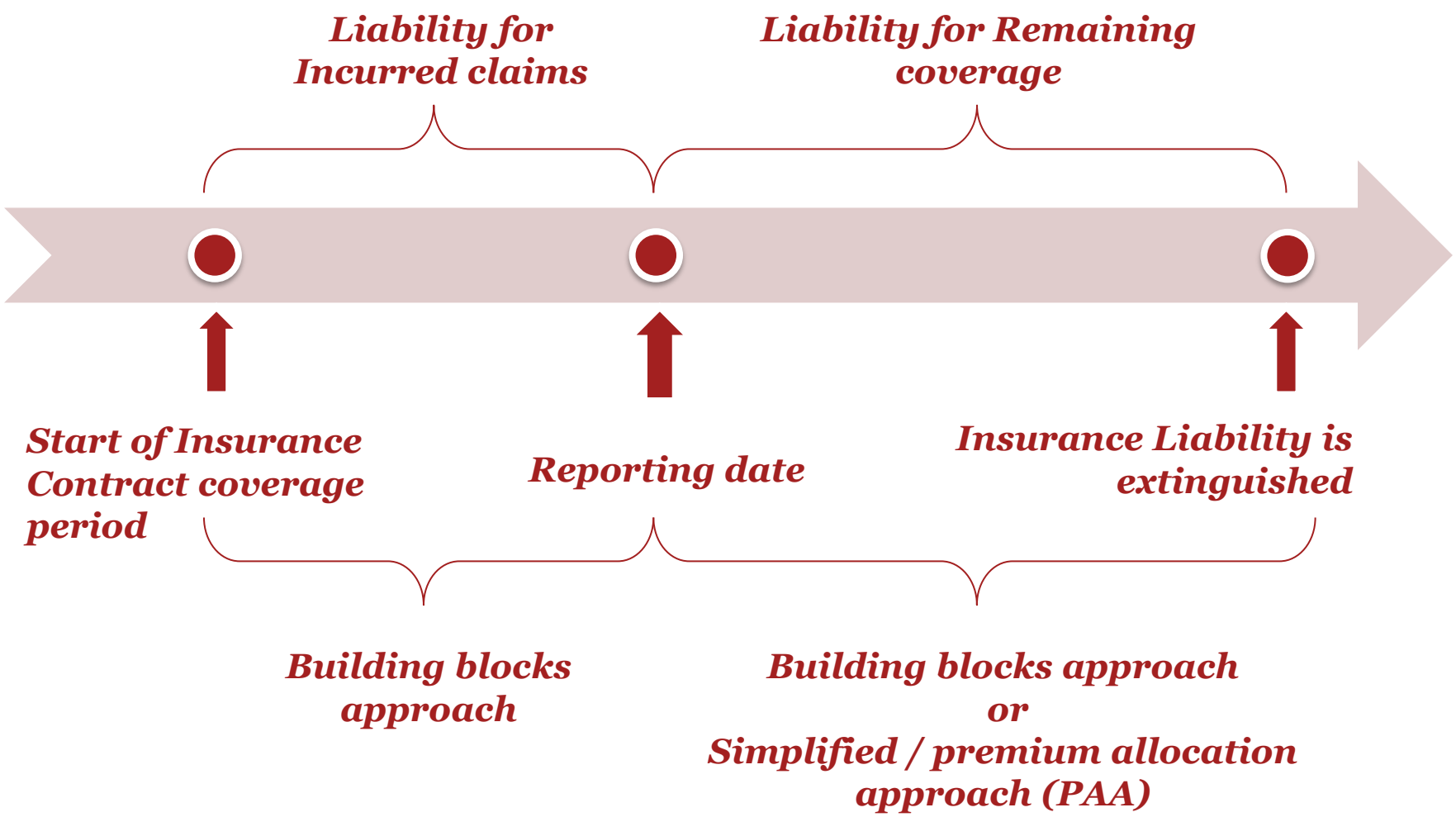
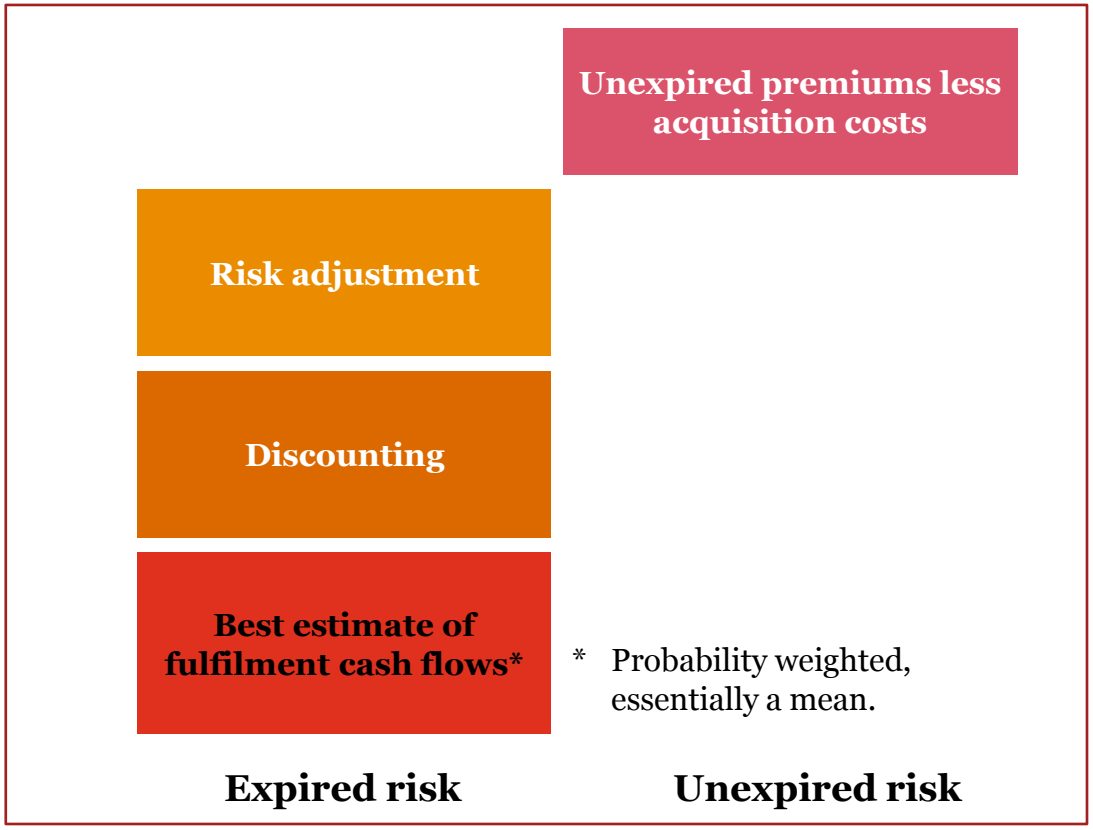
Premium allocation approach



Premium allocation approach

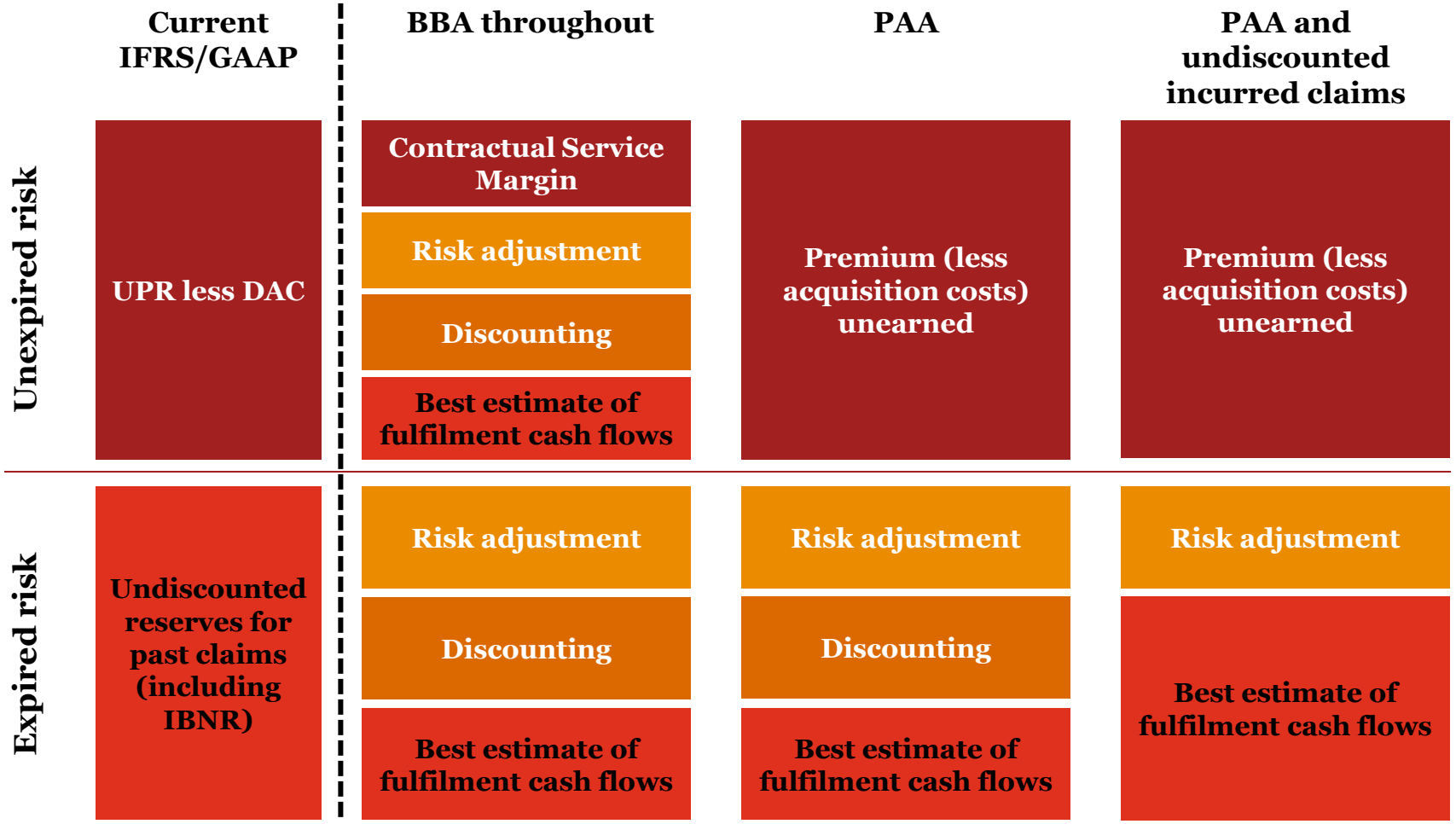
- Optional simplified model for future cover based on the unearned premium.
- Permitted for short duration contracts (period of cover <= 1 year) or where a 'reasonable approximation' of BBA.
- 'Reasonable approximation' does not apply when entity expects significant variability in cash flows – No further guidance on what this means.
- Incurred claims liability (including IBNR) calculated in the same way as for the BBA approach.



A half-way house between old GAAP and SII?

Premium allocation approach

Measurement models for general insurers



Premium allocation approach
Other decisions

Pattern of services under PAA

- Revenue reflects passage of time and expected number of contracts in force
- If this does not reflect pattern of release of risk, revenue is earned on basis of expected timing of incurred claims and benefits
- If straight line presumption is rebutted, revenue recognition is based entirely on expected claims
- Assess pattern of claims for each type of product

Use of OCI

- Rates are locked-in at date liability for incurred claims is recognised, rather than at contract inception

Insurance contracts

Other topics

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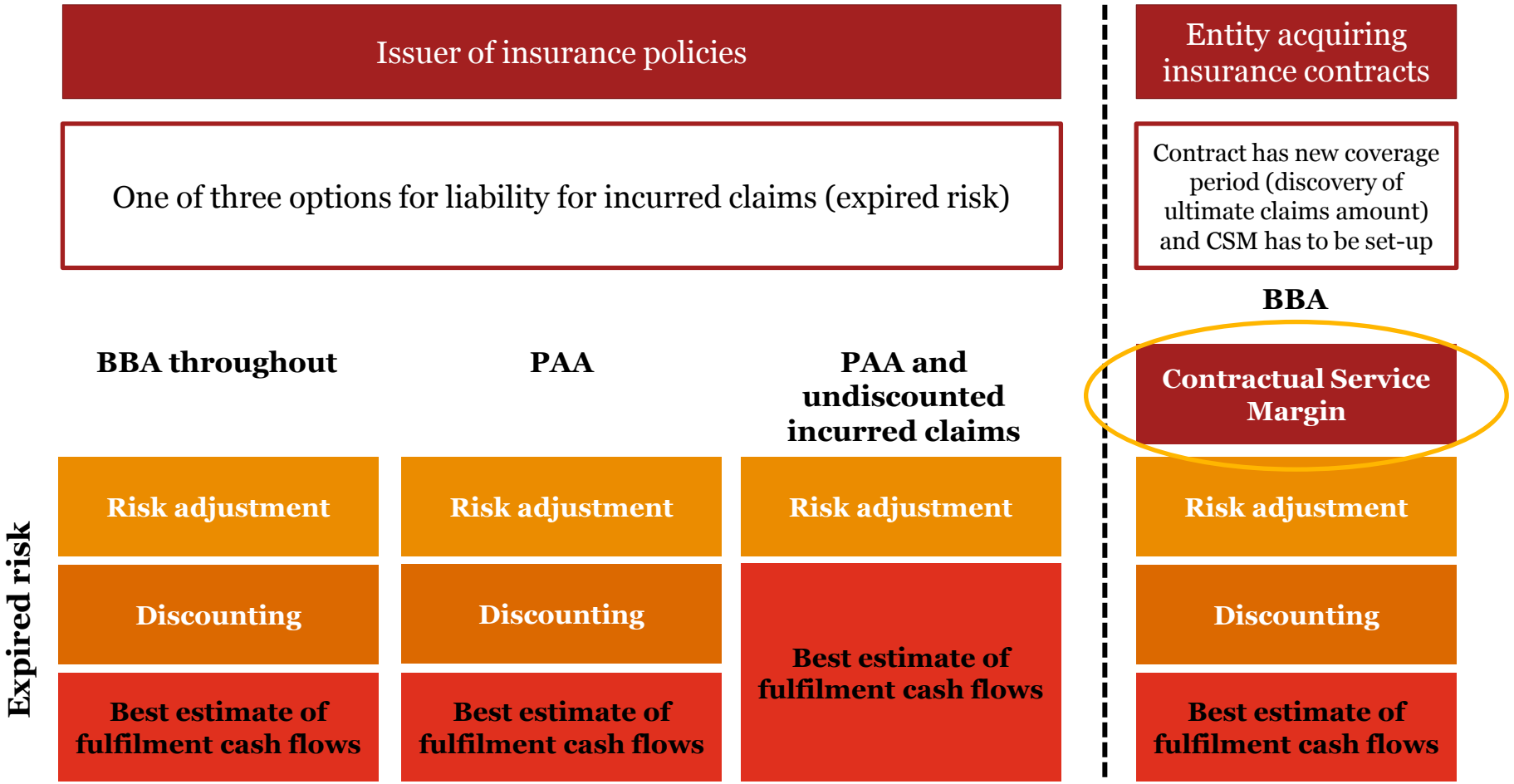
Business combinations and portfolio transfers

Long-tail contracts acquired in the settlement period



Examples could be liability insurance/bodily injury, asbestos, workers compensation

Reinsurance contracts

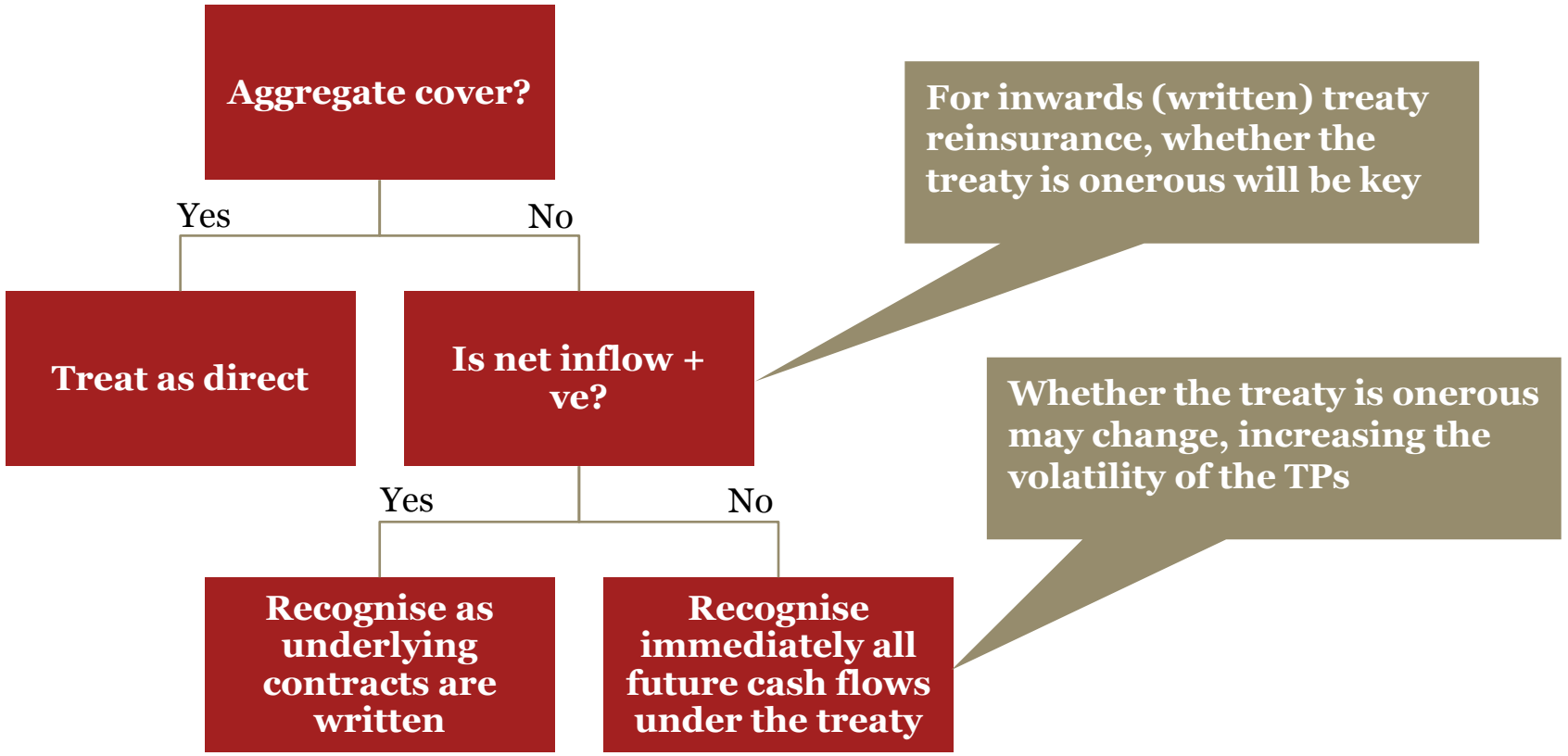
Recognition: Held reinsurance

Outwards (held) reinsurance contracts are recognised and included in the financial statements at :

- The beginning of the coverage period, if the reinsurance covers aggregate losses on a portfolio; or otherwise,
- When the underlying contracts are recognised.

Reinsurance contracts

Recognition: Inwards (written) reinsurance



Reinsurance contracts

Cash flows

- Assumptions consistent with underlying contracts.
- Recoveries and ceding commissions dependent on claims as part of claims.
- Ceding commissions not contingent on claims as a reduction in reinsurance premium.

Interaction between profitable reinsurance and onerous direct insurance contracts

- Changes in cash flows on reinsurance contracts after inception that offset losses on direct insurance contracts are recognised in profit or loss.
- For profitable reinsurance contracts at inception that offset losses on direct insurance contracts, a CSM is still recognised

Reinsurance contracts

Impact of outwards reinsurance

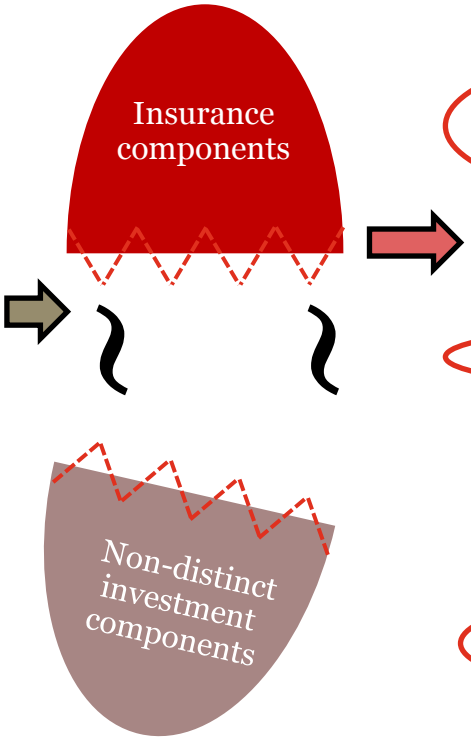
- If expected cash flows are positive (net inflows) → deferred gain.
  - If the deferred gain relates to:
    - Future events → recognise over coverage period
    - Past events → recognise over settlement period
- If expected cash flows are negative (net outflows):
  - If the loss relates to:
    - Future events → defer and expense over coverage period
    - Past events → recognise immediately
- Risk adjustment represents risk being transferred to issuer of reinsurance contract
- Non performance risk of reinsurer is included in expected cash flows
- Use of OCI for changes in discount rates is optional

Presentation
Income statement

Contractual service margin

Risk adjustment

Current unbiased probability weighted estimates of present value of future cash flows



Revenue and expense are recognised as services delivered and incurred respectively

Interest expense is current or locked-in depending on accounting policy choice

	20XX	20XX
Insurance contracts revenue*	X	X
Incurred claims and expenses	(X)	(X)
Underwriting result	X	X
Investment income	X	X
Interest insurance liability	(X)	(X)
Net interest and investment income	X	X
Profit or loss	X	X
Gains and losses on financial assets at FVOCI	X	X
Effect of discount rate changes on insurance liability (optional)	(X)	(X)
Total comprehensive income	X	X

If OCI option is chosen, difference between current and locked-in rates are presented in OCI

* Presentation of premium information that is not consistent with commonly understood notions of revenue, such as premiums due or premiums written, is prohibited.

Participating contracts

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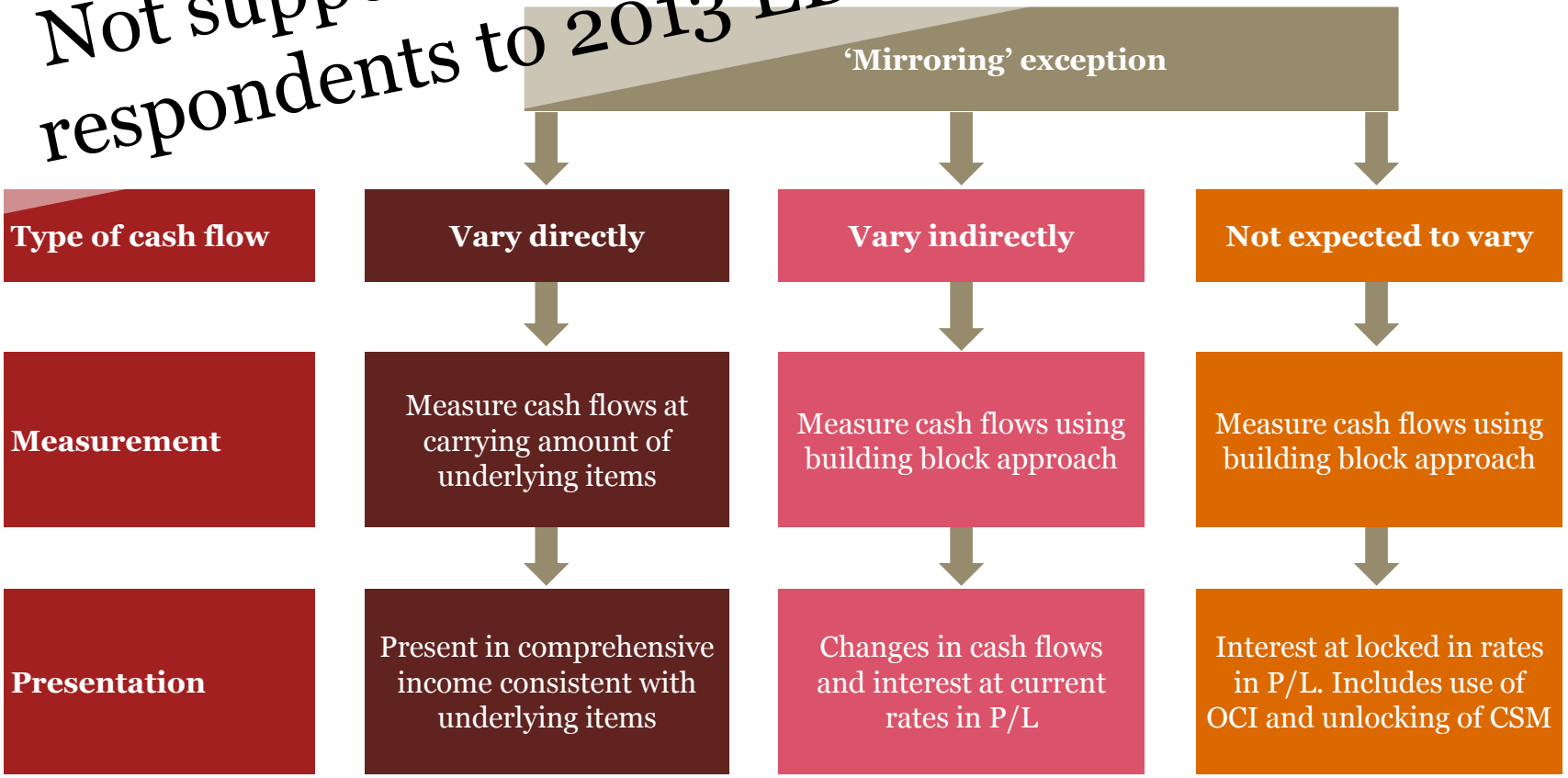
Participating contracts

Proposal in 2013 exposure draft

Not supported by most respondents to 2013 ED



Participating contracts
IASB's 'Variable fee for service' model

- Separate model for certain participating contracts proposed by IASB staff
- Staff views insurer's share in underlying returns as an implicit 'variable fee for service'
- All of the following criteria are needed to qualify for variable fee for service model:

  a) The contract specifies that the policyholder participates in a clearly identified pool of underlying items.

  b) The entity expects that a substantial proportion of cash flows from the contract will vary with changes in underlying items.

  c) The entity expects the policyholder to receive an amount representing a substantial share of the returns from underlying items. In other words, the fee charged by the entity should not be a substantial portion of the returns.

Participating contracts

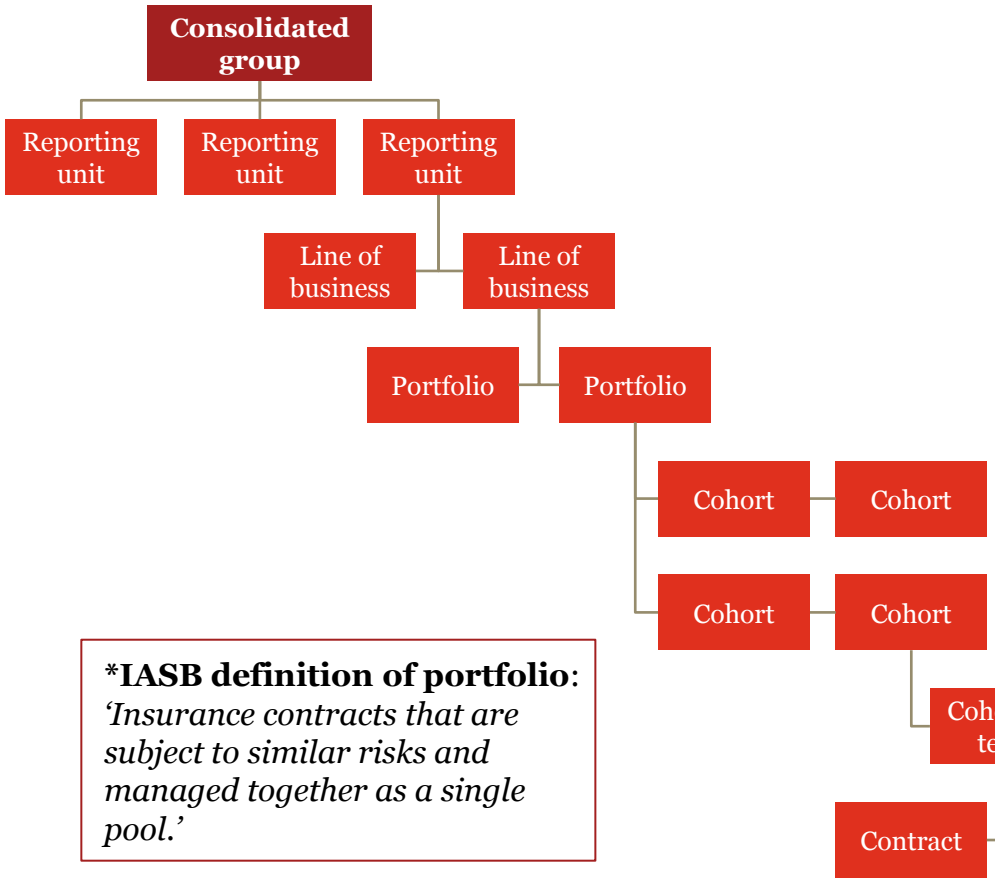
Variable fee for service model - Categories and examples

What about Chinese 70/30 contracts or Belgian contracts with full discretion?

General model	***Examples***
No cash flows that vary with returns from underlying items	• Term insurance • Whole life insurance • Inflation-linked annuity contracts?
Discretionary crediting rate with no clearly identified portfolio of underlying items specified in the contract	• Universal life

Variable fee for service model	***Examples***
Underlying items not held by insurer and contract specifies policyholder receives returns determined by reference to a clearly identified portfolio of underlying items	• Equity index-linked contracts, where assets not held
Underlying items are held by insurer and contract either: • Specifies the policyholder receives returns on underlying items held with no discretion **OR** • specifies the policyholder receives returns on underlying items held but subject to discretion	 • Unit-linked contracts • US variable annuities • Equity index-linked contracts, where assets held • Continental European 90/10 contract • UK with profits contracts

Participating contracts
Unit of account for the BBA and PAA



Component	Unit of account
Fulfilment cash flows	Contract/portfolio (e.g., in allocating overhead)
Onerous contract test (prior to recognition)	Portfolio
Discount rate	Liability characteristics at initial recognition
Contractual service margin – Recognition	Individual contract, but can aggregate if it meets objective. Also not combine profit making and loss-making contracts
Contractual service margin -Unlocking	Use grouping at initial recognition
Contractual service margin – Amortisation	None stated
Risk adjustment	None stated

***IASB definition of portfolio**: *'Insurance contracts that are subject to similar risks and managed together as a single pool.'*

Significant impact on modelling and data requirements

The intention of the IASB is to have a similar unit of account for the onerous contract test under the PAA and BBA

Participating contracts
Unit of account

Staff proposal February 2015

- Objective is to measure individual contracts
- Losses from financial risks for current generation of policyholders cannot be combined with profitable contracts of the previous generation or contracts to future policyholders

Aggregation does not meet the objective in case of:

- Significantly different explicit fees
- Different levels of exposure to mortality risk (for example a contract with life cover and a contract without life cover)
- Differing levels of exposure to financial risks (i.e. embedded financial guarantees)

Board discussion February 2015 – Participating contracts

- IASB noted that impact of discretion is an important factor to consider in determining the level of aggregation for participating contracts
- Board recognises that this needs to be explored further.

Participating contracts
Comparison of IASB models

	General model	**Variable fee for service model**
Examples	*Whole life insurance, term insurance, universal life*	*Unit-linked, equity index-linked, 90/10, UK with profits contracts*
1. Building blocks at inception	• Present value of expected cash flows • Risk adjustment • Contractual service margin ('CSM')* *In variable fee for service model the CSM is effectively the "insurer's share" of returns, represented as the present value of expected variable fees minus related costs	
2. Changes in insurer's share in underlying items	• Recognise changes in underlying items in line with IFRS 9 (likely OCI or profit or loss)	• Recognise in CSM
3. Changes in options and guarantees	• Recognise according to general model in CSM (non-financial assumptions), OCI or profit or loss (depending on policy choice for changes in discount rate)	• Recognise in CSM
4. Changes in estimates from non-financial assumptions (including application of discretion and risk adjustment)	• Recognise in CSM if related to future services • Recognise in profit or loss if related to current or past services	
5. Allocation of CSM in profit or loss	• Allocate on basis of passage of time** • Reflect the number of contracts remaining in force** **Still in discussion for variable fee for service model.	

Participating contracts
Comparison of IASB models

	General model	**Variable fee for service model**	
Examples	*Whole life insurance, term insurance, universal life*	*Equity index-linked**	*Unit-linked, 90/10, UK with profits, Equity index-linked*
Underlying items	*Not clearly identified*	*Not held*	*Held*
6. Accretion of interest on CSM	• Rate at inception of the contract	• Implicitly included in liability measurement	
7. Discount rate unlocking CSM	• Rate at inception of the contract	• Current rate	
8. Interest expense and OCI	• Apply rate at inception, for interest expense and current rate through OCI **OR** • Apply effective yield when, either: ○ Contract does not meet criteria for 'variable fee or service model'(E.g. contract provides for a discretionary crediting ○ Contract meets criteria for 'variable fee or service model but entity does not holds the underlying items • For effective yield, 'level yield' or 'projected crediting' rate still under discussion • Effect of changes in discount rates in OCI	• Apply effective yield approach as in general model.	• Apply 'current period book yield approach' (effectively 100% mirroring in profit or loss)** • Difference between liability change due to discounting using a current rate and current period book yield recognised in OCI
9. Reassessment	• Determine accounting approach at inception with no reassessment		

* An entity can choose to hold different assets compared to the equity index
** If entity no longer holds the underlying items, the current period book yield approach can no longer be applied for the remainder of the contract

Participating contracts
Impact of variable fee for service model

Underlying*	Investment income	Interest expense	Other comprehensive income
Instruments at FVPL	• FV change of underlying item	• Mirror FV change of underlying item	• Not applicable • No mismatch
Bonds at FVOCI	• Effective interest rate • Impairments	• Mirror effective yield and impairments	• Assets: FV changes caused by changes in market interest rates • Liabilities: Effectively mirrors amounts on assets in OCI • No mismatch
Bonds at AC	• Effective interest rate • Impairments	• Mirror effective yield and impairments	• Assets: Not applicable • Liabilities: Difference between change in fulfilment cash flows related to underlying items and interest expense in profit or loss • Leads to mismatch in equity; reverses upon sale of bond
Investment property at cost	• Rental income	• Mirror rental income	• Assets: Not applicable • Liabilities: Difference between change in fulfilment cash flows related to underlying items and interest expense in profit or loss • Leads to mismatch in equity; reverses upon sale of investment property
Equities at FVOCI	• Dividend income • No impairment	• Mirror dividend income	• Assets: FV changes other than dividend income • Liabilities: Difference between change in fulfilment cash flows related to underlying items and interest expense in profit or loss • No mismatch

* The effect in profit or loss for underlying items that is a share of a business operation (e.g. a combination of an investment performance, mortality and cost savings) is also reflected in the interest expense reported in the liability.

Participating contracts

Differences variable fee for service model and CFO Forum proposal

	Variable fee for service model	European industry proposal
Scope	• Contract specifies that policyholder participates in clearly identified pool of underlying items. • Entity expects that a substantial proportion of cash flows from the contract will vary with changes in underlying items. • The entity expects policyholder to receive amount representing a substantial share of returns from underlying items. • Excludes universal life contracts	• All participating contracts, including universal life
Insurer's share	• Only cash flows promised to the policyholder arising from underlying items specified in contract	• Includes projected future allocation of returns from items the entity holds, including certain derivatives
Changes in options and guarantees	• Recognise in CSM	• Recognition either in CSM, OCI or profit or loss

Participating contracts

Differences variable fee for service model and CFO Forum proposal

	Variable fee for service model	European industry proposal
Interest expense and OCI	• Current period book yield that mirrors investment returns recognised in profit or loss. • Works for all underlying items	• Current portfolio book yield by determining the basis of the accounting return (or book yield) for specified underlying items • Complicated for investment properties at cost and equities at FVOCI
** Impairment*	• Impairment automatically reflected in 'mirroring' • Eliminates accounting mismatches	• Effective interest rate should be adjusted to reflect impairment requirements of IFRS 9 • Accounting mismatch might arise when impairment losses are accounted for using IFRS 9 while insurance contract is measured on expected cash flow basis.
** Day 0 amounts in OCI*	• No amounts recognised in OCI at initial recognition	• Amounts recognised in OCI at initial recognition, because of differences between the book yield of underlying items and current rates.
Allocation of CSM in profit or loss	• Still under discussion • Staff has proposed passage of time • Not all Board members seemed to agree. Some would prefer to reflect the predominant services (insurance coverage or investment management)	• Prospective re-measurement of the CSM without further guidance

Participating contracts
Key areas still under discussion with IASB

Only education sessions have been held so far, but direction gets clearer

Key outstanding items are:

- Unit of account
- Solution for mismatches arising because of economic hedging of options and guarantees in insurance contracts
- Allocation of CSM in profit or loss

Transition

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Transition
Overview

Retrospective application

When historical data exists and hindsight is not required

Prescribed simplified approach

When not all historical information is available but information about historical cash flows is available or can be constructed

Liability calibrated to fair value

When no historical information about cash flows is available to determine the CSM

Transition
Prescribed simplified approach

- Each portfolio measured using BBA with CSM
- Difference between BBA and current carrying value reflected in opening retained earnings
- Retrospective application unless impracticable as defined in IAS 8
- If impracticable, simplifications required for building blocks:

Simplifications	Details
Cash flows	• Assume all changes in estimates known at initial recognition
Discount rate	• Estimate discount rate at initial recognition by using observable yield curve that, for at least three years before transition, approximates the yield curve applying the general model • If not available, apply spread to observable yield curve as average over at least three years before the date of transition
Risk adjustment	• Estimate risk adjustment at contract inception by adjusting risk adjustment at beginning of the earliest period presented by expected release of risk before beginning of earliest period presented.

- Derecognise balances for deferred acquisition costs

Transition
Fair value approach

- If simplified approach is impracticable, determine CSM at beginning of earliest period presented as difference between:
  - Fair value of the insurance contract at that date; and
  - Fulfilment cash flows measured at that date.

Financial assets

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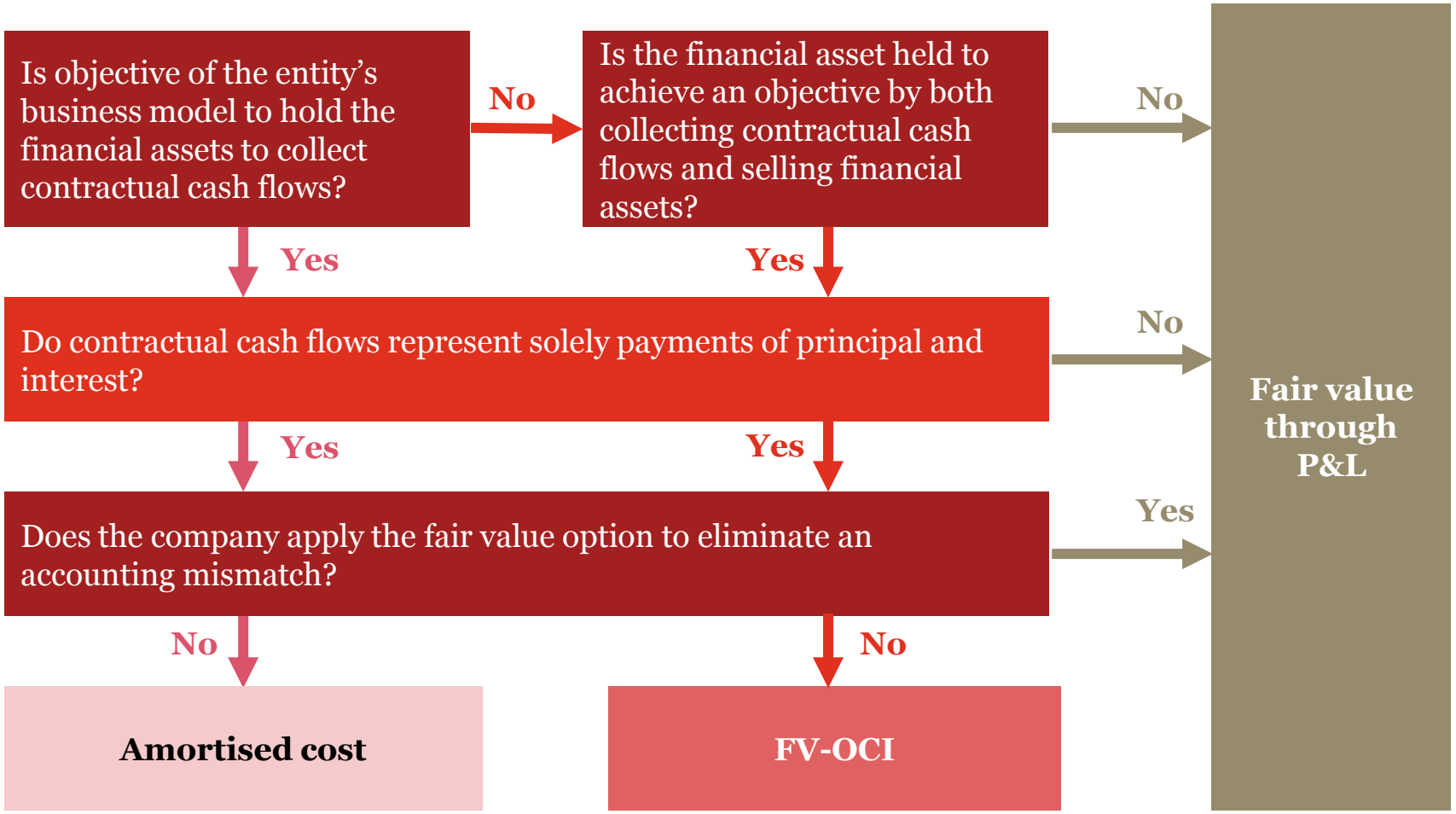
IFRS 9 – Financial assets

Overview classification and measurement



IFRS 9 – Financial assets
Potential accounting mismatches

Underlying assets	Potential mismatches
Debt at amortised cost or FVOCI	• Regular premium contracts • Debt sold before maturity
Equities at FVOCI	• Upon sale of equities or at maturity (OCI for equities is not recycled)
Derivatives, Debt at FVPL or Investment properties	• Reduced only if changes in discount rates are recognised in profit or loss • Mismatches arise if changes in discount rates are recognised in OCI

- This only applies to non-participating contracts
- Any accounting mismatches for participating contracts are still unclear

IFRS 9 – Financial assets
Existing transition relief in 2013 ED

Follow reclassification guidance IFRS 9 (i.e. no reclassification permitted unless change in business model). On adoption of the insurance contracts standard:

- Designate eligible financial assets under FVO where new accounting mismatches created;
- Require to revoke previous designations under FVO where accounting mismatch no longer exists; and
- Permit to newly elect to use OCI for presentation of changes in fair value of some or all equity instruments that are not held for trading, or revoke previous election

IFRS 9 – Financial assets

Additional transition relief

- Effective dates of IFRS 9 and IFRS 4 phase II will not be aligned
- IFRS 9 will not be delayed in full or for insurers only
- IASB will consider additional transition relief for IFRS 9 upon adoption of IFRS 4 phase II
- Re-assessment of business model in IFRS 9 is main alternative
- Prospective or retrospective application is to be decided
- Effective date of IFRS 4 phase II to be discussed at future meeting

IFRS 9 – Financial assets

Expected credit losses - General model

Change in credit quality since initial recognition

Recognition of expected credit losses

12 month expected credit losses	Lifetime expected credit losses	Lifetime expected credit losses

Interest revenue

Effective interest on gross carrying amount	Effective interest on gross carrying amount	Effective interest on amortised cost carrying amount (i.e. net of credit allowance)

Stage 1	**Stage 2**	**Stage 3**
Performing (Initial recognition*)	*Underperforming* (Assets with significant increase in credit risk since initial recognition*)	*Non-performing* (Credit impaired assets)

**Except for purchased or originated credit impaired assets*

3

How are insurers preparing?

Preparing for the next steps

Lobbying efforts	• Limited opportunities to influence the debate
Impact study	• Plan for a plan • Identifying best time for planning a more detailed impact assessment
Interactions with wider change initiatives	• Sizing scale (including resource and system requirements) and determining when activities should occur • Interaction with Solvency II and other finance change initiatives

Current status and market activity

Topics on a CEO/CFO Agenda

How long after the release of IFRS do you think it will be before analysts start asking about its impact?

Exactly how well do you understand the IFRS profit profiles of your products and the overall impact on your published numbers?

If your peers are ahead of you would this be a concern?

In case you have issued multi-year forecasts to the market, are you aware of the potential impact of IFRS 4 Phase II on these forecasts?

IFRS phase 2 – the scale of the practical impact

#	Key future state component	Minimal	Low	Medium	High
1	Scope	●			
2	Contract boundary		●		
3	Unbundling		●		
4	Best estimate cash flows			●	
5	Acquisition costs			●	
6	Discount rate			●	
7	Risk adjustment			●	
8	Contractual service margin				●
9	Participating (asset linked) contracts				●
10	Reinsurance			●	
11	PAA			●	
12	Transition				●
13	Presentation & disclosure				●

Current status and market activity
Typical activity

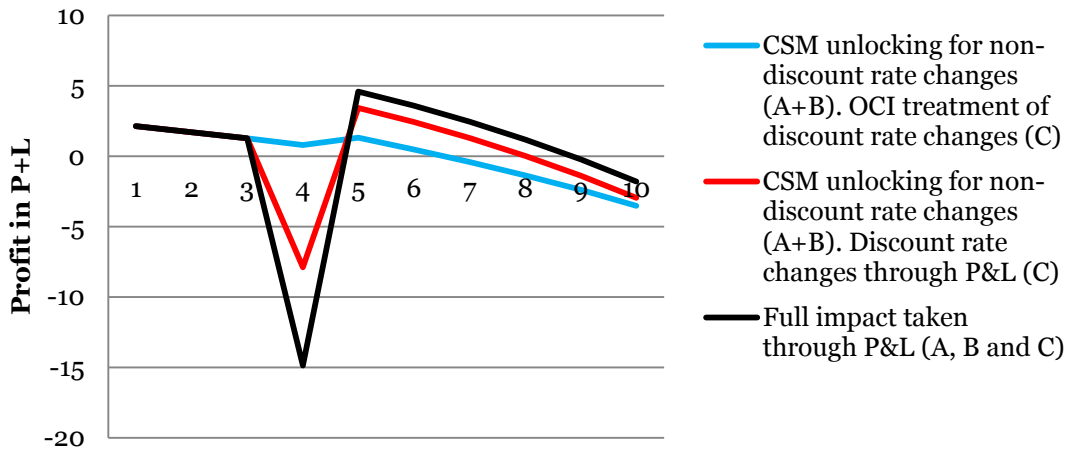
- Pre-study on IFRS 4 and 9 implementation.
- Strategic planning for implementation of IFRS 4 Phase II, IFRS 9 and IFRS 15
- Initial planning
  - financial impact assessments
  - assessing system & process implications and operational impact on (pilot) business units
- Implementation planning and cost estimation for business case
- Search for skilled resources

Financial impact

Understanding the impact on profit and equity

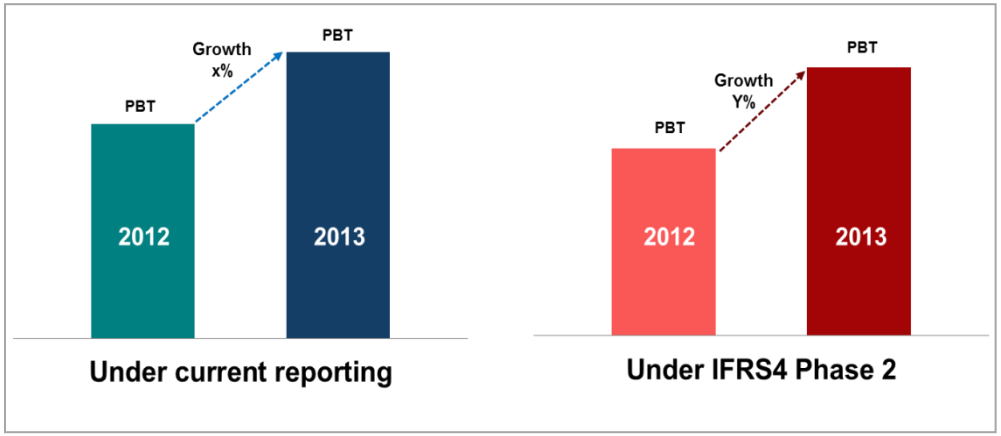
Product level

Profit signatures

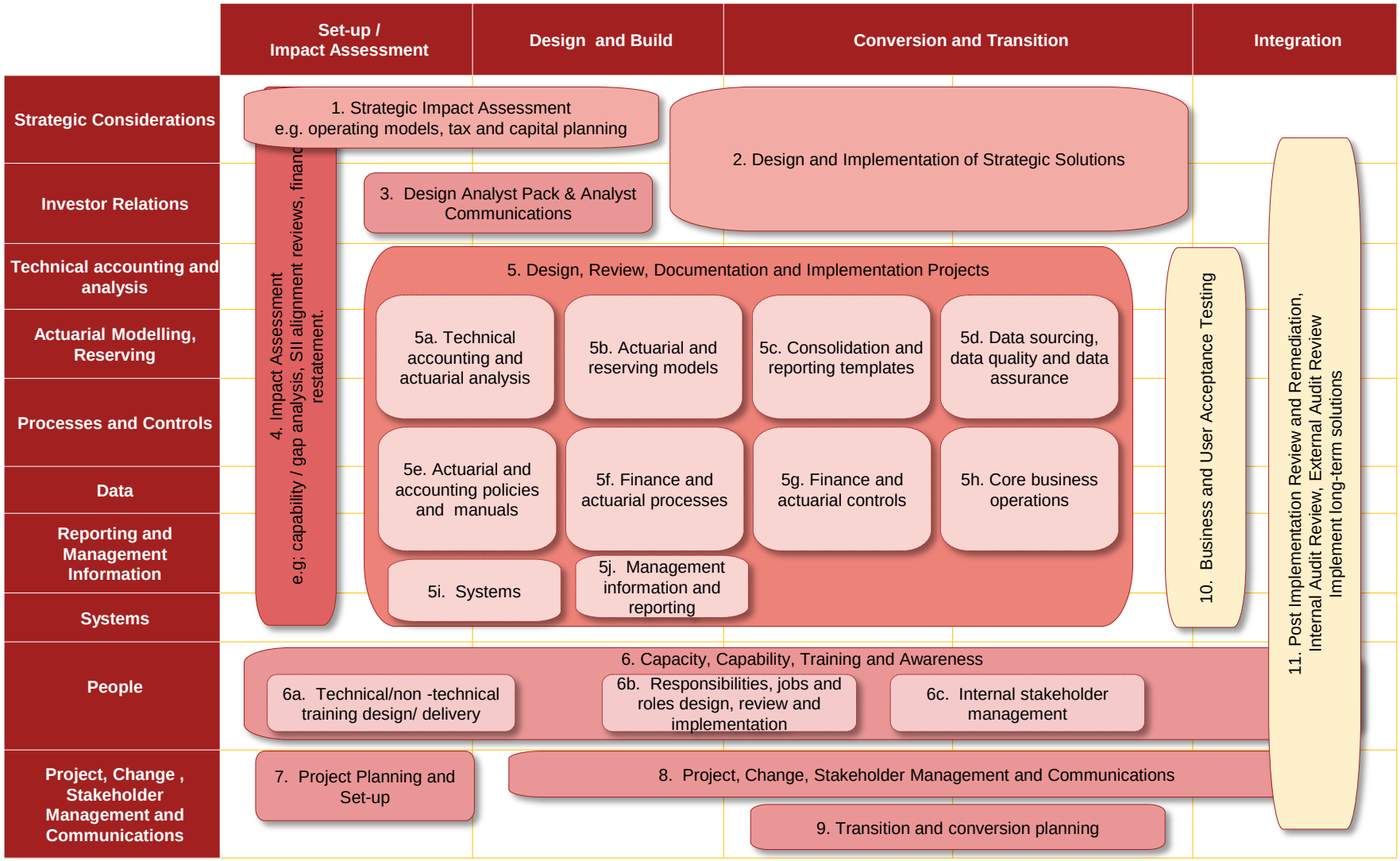


Company level

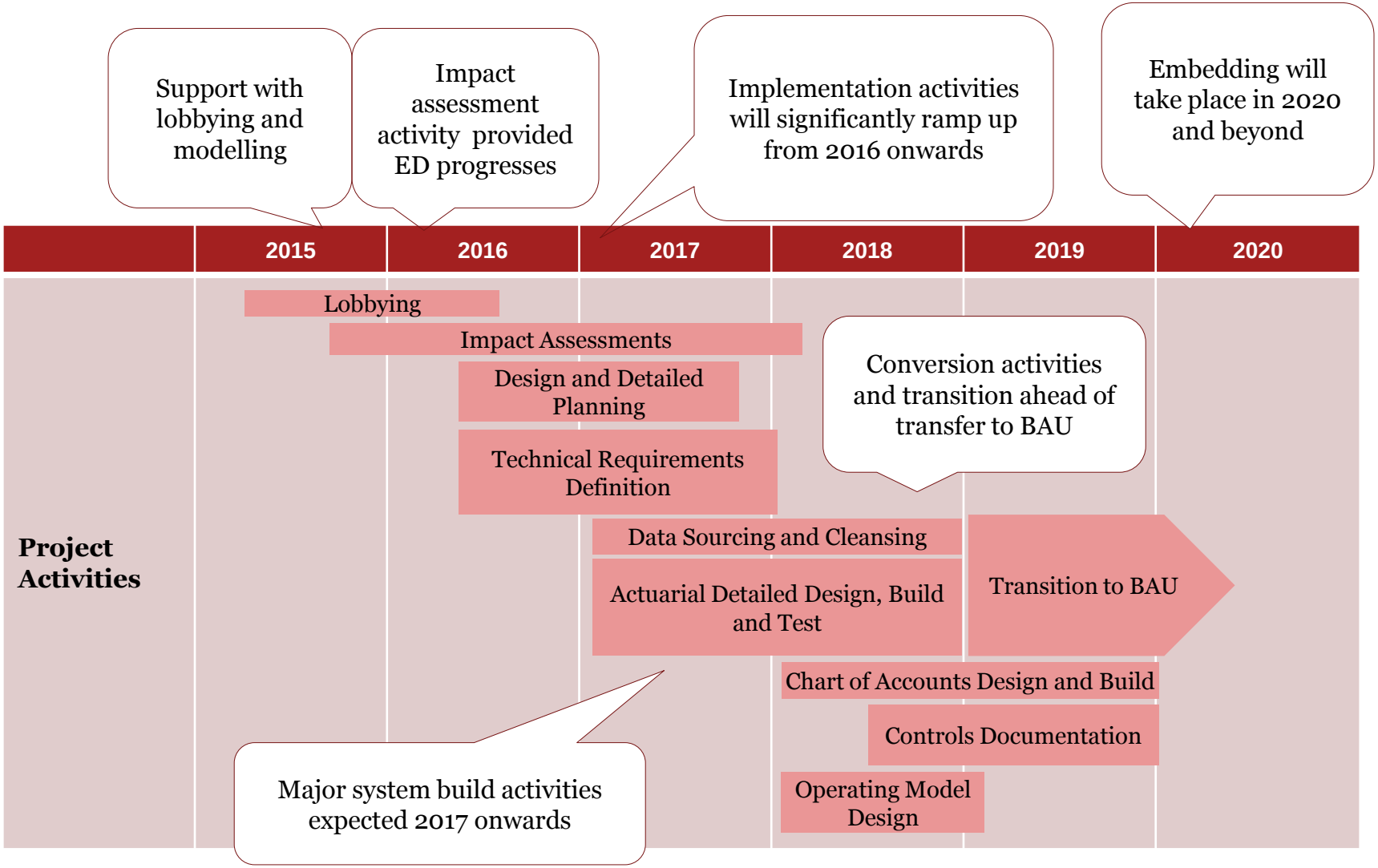
Balance sheet and profit-drivers



Implementation likely to be a complex project



Timeline and illustrative roadmap to 2019



Further reading

Recommended reading

IASB insurance contracts project page

http://www.ifrs.org/current-projects/iasb-projects/insurance-contracts/Pages/insurance-contracts.aspx

- Exposure drafts
- Education session slides/webcasts
- Summaries of feedback

PwC insurance contracts update page

http://www.pwc.com/gx/en/insurance/ifrs/progress.jhtml

- Minutes from IASB meetings, in advance of official minutes
- Webcast
- Thought leadership

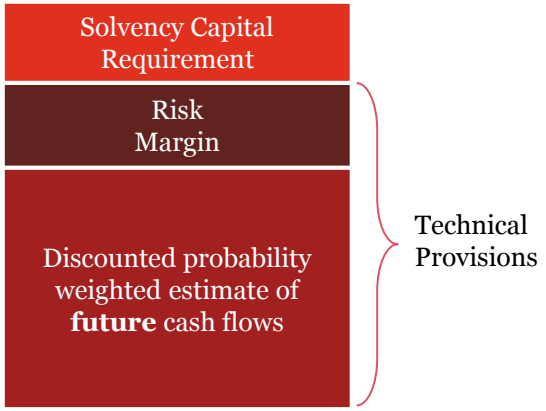
Appendix

Solvency II versus IFRS for insurance contracts

Solvency II versus IFRS for insurance contracts

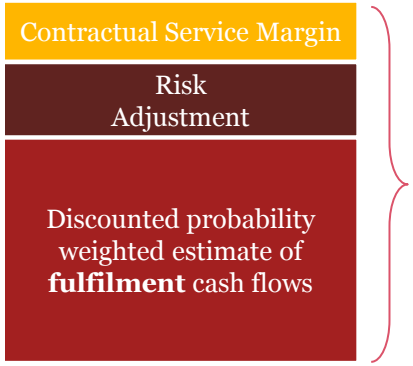
Overview – contract liabilities

Solvency II



- Risk margin = Sets the technical provisions as the expected amount required to take over and meet the obligations.
- As a regulatory regime, there is a capital requirement– the Solvency Capital Requirement (SCR)

IFRS – Insurance Contracts (BBA)



- Risk adjustment = Compensation the insurer requires for bearing the uncertainty inherent in the cash flows that arise as the insurer fulfils the contract
- Contractual service margin is set to avoid a day one gain
- Certain acquisition costs are included in the fulfilment cash flows resulting in implicit deferral of these costs.

IFRS – Investment Contracts

- All financial liabilities are classified as fair value through profit and loss or amortised cost
- Initial measurement is at fair value. Subsequent measurement is at fair value (subject to a "deposit floor") or at amortised cost depending on classification
- Model contains deferral of acquisition costs and upfront fees

Solvency II versus IFRS for insurance contracts

- Many of the building blocks are expected to be similar, however, there are likely to be a number of differences:
  - Best estimate liability – Different cash flows (e.g. certain expenses and relevance of acquisition expenses)? Different contract boundary?
  - Discount rate – Restrictions in Solvency II matching adjustment versus IFRS top down approach?
  - Risk adjustment – Calibration differences due to different philosophy? (e.g. fulfilment versus transfer value)
  - Contractual Service margin – Not relevant in Solvency II and new modelling systems will be required !
  - Treatment of "participating" contracts – Unclear?
  - The need for transition – IFRS is a retrospective standard while Solvency II is prospective looking.
- Non-participating investment contracts will be different to Solvency II (due to deferral / matching in IFRS).

Solvency II versus IFRS for insurance contracts
Comparison

Topic	IFRS	Solvency II	Significance	Observations
Definition and scope	Insurance and participating investment	All contracts		• The measurement of investment contracts in Solvency II is likely to be significantly different to IFRS.
Recognition	Date coverage begins (plus onerous contact test for earlier periods)	Date party to contract		• Significance of any difference will depend on the onerous contract test in IFRS. For many long term contracts the recognition will be the same.
Unbundling	Distinct investment components, embedded derivatives and certain goods and services	No		• Potential requirement to unbundle asset management service components in IFRS would be different to Solvency II. • Revenue items are not presented on the IFRS income statement for non-distinct investment components.
Contract boundary	No longer required to provide coverage or contract does not confer any substantive rights to policyholder	Amend terms to 'fully reflect risk' No projection of premiums for savings contracts		• Some similarity between IFRS and Solvency II for savings contracts with no insurance risk? • In Solvency II (unlike IFRS), there is a requirement to separate contracts into components, where the contract boundary differs between components. • Devil will be in the detail when the distinct definitions are considered in view of contract terms (notably for health and reviewable term contracts).

Solvency II versus IFRS for insurance contracts
Comparison (continued)

Topic	IFRS	Solvency II	Significance	Observations
Cash flows (excluding acquisition)	Incurred directly to fulfil portfolio of contracts	Prescribed		• Potential risk of differences in certain cash flows, for example, certain expenses and taxes.
Acquisition costs	Directly attributable at portfolio level	Expensed as incurred		• In IFRS, there is "implicit" deferral of acquisition costs. There is no equivalent concept in Solvency II.
Discount rate	Top down or bottom up (current or locked-in depending on option)	Prescribed based on swaps + Matching adjustment OR Volatility adjustment		• Solvency II concept of the matching adjustment is similar to the IFRS top-down approach. • Would the volatility balancer be permitted in IFRS? • No concept of locking-in / OCI in Solvency II (current rates only are used).
Risk adjustment	No prescribed method (fulfilment value)	Prescribed 6% cost of capital (transfer value)		• IFRS less prescriptive so there is potential for calibration difference between a Solvency II and IFRS cost of capital assessment (e.g. different objectives, cost rate, diversification benefit etc.) • Additional complexity and stochastic modelling to prepare confidence interval disclosure in IFRS.
Contractual service margin	Eliminate day-one gain (unlocked for certain subsequent changes)	No		• No equivalent concept of deferral-and-matching (through the contractual service margin) in Solvency II.

Solvency II versus IFRS for insurance contracts
Comparison (continued)

Topic	IFRS	Solvency II	Significance	Observations
Participating contracts	Decomposition of cash flows into those that vary directly, indirectly or do not vary by the underlying assets (An areas under extensive IASB re-deliberation!)	Cash flows from participating feature included (except for "approved surplus funds")		• For directly linked cash flows, the linkage of the cash flows in IFRS to the measurement and presentation of support assets ("mirroring") is a significant difference to Solvency II if assets are not FVTPL. • IFRS and Solvency II will both contain a stochastic valuations to capture options and guarantees (likely to be market consistent?) • The treatment of residual participating fund assets and the allocation between liability and equity will depend on the specific nature of the contracts and national law.
Short duration contracts	Pre claims liability: Optional unearned premium model (known as Premium Allocation Approach) Claims liability: Projection of future cash flow	As for other contracts		• In IFRS, the unearned premium model is optional. A cash flow approach can be adopted as in Solvency II.

Thank you